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Abstract

On February 11, 2011 the US Treasury published a white paper announcing the future dismantling of the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac.1 This white paper, "Reforming America's Housing Finance Market," was a result of the government bailout and conservatorship of the GSEs. While both GSEs are well known for their role in residential real estate, their recent involvement in multifamily real estate is less apparent. The purpose of this report is twofold: First to explain the role GSEs have played in the multifamily mortgage market; and second to postulate the effect their non-participation will have on the future of multifamily properties and financing.

Keywords

US Treasury, white paper, government-sponsored enterprises, GSE, Fannie Mae, Freddie Mac, "Reforming America's Housing Finance Market", government, bailout, conservatorship, multifamily, mortgage, market, properties, financing, 1990, recession, CMBS, commercial mortgage-backed securities, MBS, mortgage-backed securities, RMBS, residential mortgage-backed securities, supply, demand, interest rates, property prices, construction starts, future trends, uncertainty, subprime, recovery, Private-Label MBS, cycles, securitization, volume, asset, type, future, cap rates, treasury yields, increase, future, Cornell, real estate

How Dismantling Fannie Mae and Freddie Mac Will Affect the Future of the Multifamily Market

By David Shlomi and Andrew Benioff

Author

David Shlomi is a 2012 Cornell Program in Real Estate Candidate. A native of Los Angeles, California, David graduated with a bachelor's degree in Business Administration from the University of Southern California. During his undergraduate studies, he developed a passion for real estate and has since gained significant work experience in different facets of the industry, including property management, residential and commercial brokerage, property valuation, and short sales. In the upcoming summer of 2011, David will be interning at Biomed Realty Trust as a summer associate within its finance department. Upon completion of his master's degree, David plans to pursue a career in real estate development and investment.

On February 11, 2011 the US Treasury published a white paper announcing the future dismantling of the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac.[1] This white paper, "Reforming America's Housing Finance Market," was a result of the government bailout and conservatorship of the GSEs. While both GSEs are well known for their role in residential real estate, their recent involvement in multifamily real estate is less apparent. The purpose of this report is twofold: First to explain the role GSEs have played in the multifamily mortgage market; and second to postulate the effect their non-participation will have on the future of multifamily properties and financing.

The research in this report shows that while dismantling the GSEs will have an immediate negative impact on multifamily property values, ultimately, there can be a healthy multifamily market without GSEs. In order to develop this conclusion, the following topics will be discussed: the role of the GSEs before and after the 1990 recession to the present day, the CMBS market, supply and demand characteristics (interest rates, property prices, construction starts, etc...) and future trends that can affect the multifamily market.

It should be noted that there is much uncertainty surrounding the Administration's white paper and what the ultimate outcome will be. For example, the length of time it will take to dismantle Fannie and Freddie and the extent of privatization are unknown. For the purpose of this paper, however, one must assume that the multifamily mortgage market, excluding low-income housing, will be completely privatized.

Background:

Fannie Mae and Freddie Mac are well known for their dominance of the single-family mortgage market, but their active involvement and dominance in the multifamily market is a more recent occurrence. Prior to the unprecedented growth in subprime mortgages, the two GSEs owned or guaranteed over 50% of the United States' home mortgages and purchased about 45% of multifamily mortgages.[2] However, by 2008, the mortgage market had crashed and the two GSEs remained only as a result of the US government bailout and conservatorship. In 2009, Fannie Mae and Freddie Mac accounted for nine in every ten home loans and over 84% of all multifamily loans originated.[3]

The crash of subprime mortgages brought the GSEs to the brink of collapse, but conservatorship has led to their extraordinary growth and current dominance of the single and multifamily mortgage markets. The GSEs have helped keep the debt markets liquid by purchasing and guaranteeing loans. On the other hand, most private lenders have not been able to compete with these subsidized government entities. Consequently, the lack

[1] The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), Government Sponsored Enterprise (GSE)

[2] Time frame is 2001 through 2003, Source: FHFA "Fannie Mae's Role In The Small Multifamily Loan Market"

[3] Source: Center for American Progress

of private lending has led the Obama Administration to lay out a plan to reform the US mortgage market without GSEs.

History of the Multifamily Mortgage Market

According to Fannie Mae and Freddie Mac, the multifamily mortgage market is a component of the commercial real estate market. While multifamily property is not considered a commercial building, it must contain multiple units and produce income to be considered commercial real estate. In the early 1980's, financial service vehicles were established to provide liquidity to the secondary multifamily mortgage market. Among these established vehicles were Fannie Mae and Freddie Mac.

Fannie and Freddie were established as private government sponsored enterprises in 1968 and 1970, respectively. They are shareholder owned corporations that were established with the goal of providing stability, assistance, and liquidity to the secondary market for residential mortgages. It was not until the mid 1980's that the GSEs began to take an active role in purchasing multifamily loans.[4] Around the same time, the secondary market began to experience significant changes.

In the mid 1980's the multifamily mortgage market experienced four structural changes that made debt financing more difficult to obtain.[5] First, due to imprudent lending and a reduction in tax incentives, the thrift industry experienced a drastic decline in its share of multifamily mortgage origination, decreasing from 36.6% to 9.9% between 1989 and 1995. Second, in response to numerous bank failures during this period, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, which imposed stricter underwriting criteria for multifamily lending. Third, FHA insured mortgages experienced a significant decline as they fell from 30% to 5%, between the mid 1980's and 1992. Lastly, the removal of tax-favored status of rental housing decreased the attractiveness of multifamily investments. These four changes were intensified by the 1990 recession, which saw a 47% drop in construction starts between 1990 and 1991.[6]

The 1990 Recession and Recovery

Structural changes in the multifamily market helped lead to the 1990 recession and commercial real estate meltdown. Between the first quarter of 1990 and the third quarter of 1993, values of multifamily real estate stock declined 16.7%.[7] This led Freddie Mac to cease most of its involvement in the multifamily sector. On the other hand, Fannie Mae still played a role in the multifamily market, but was not a major player until around 1996, well after the recession.

By 1993 the recovery had begun and GSE transaction volume slowly began to pick up. Additionally, in 1995, HUD issued a rule establishing GSE housing goals, which targeted a minimum annual dollar amount of multifamily mortgages for affordable housing.[8] This rule did not have a major effect on the market until 1998 and, therefore, did not have a direct impact on the recovery of the multifamily market between 1993 and 1996. The exhibit below displays the lack of transactions by Freddie Mac, in relation to later years, as well as the 1998 spike in transaction volume by both GSEs. Fannie Mae and Freddie Mac did not play a significant role in the recovery of the multifamily market and, in 1994, represented less than 20% of the origination market.[9]

[4] It should be noted that Fannie Mae's presence in the multifamily market is larger than Freddie Mac's.
[5] Source: Segal and Szymanoski, "The Multifamily Secondary Mortgage Market: The Role of Government-Sponsored Enterprises"
[6] Source Segal and Szymanoski, "The Multifamily Secondary Mortgage Market: The Role of Government-Sponsored Enterprises"
[7] Source: Bradley, Nothaft, and Freund, "Financing Multifamily Properties: A Play With New Actors And New Lines"
[8] Housing and Urban Development: an executive branch of the US government that develops and executes policies on housing
[9] Source: Segal and Szymanoski, "The Multifamily Secondary Mortgage Market: The Role of Government-Sponsored Enterprises"

"It was not until the mid 1980's that the GSEs began to take an active role in purchasing multifamily loans."

Author

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Figure 1

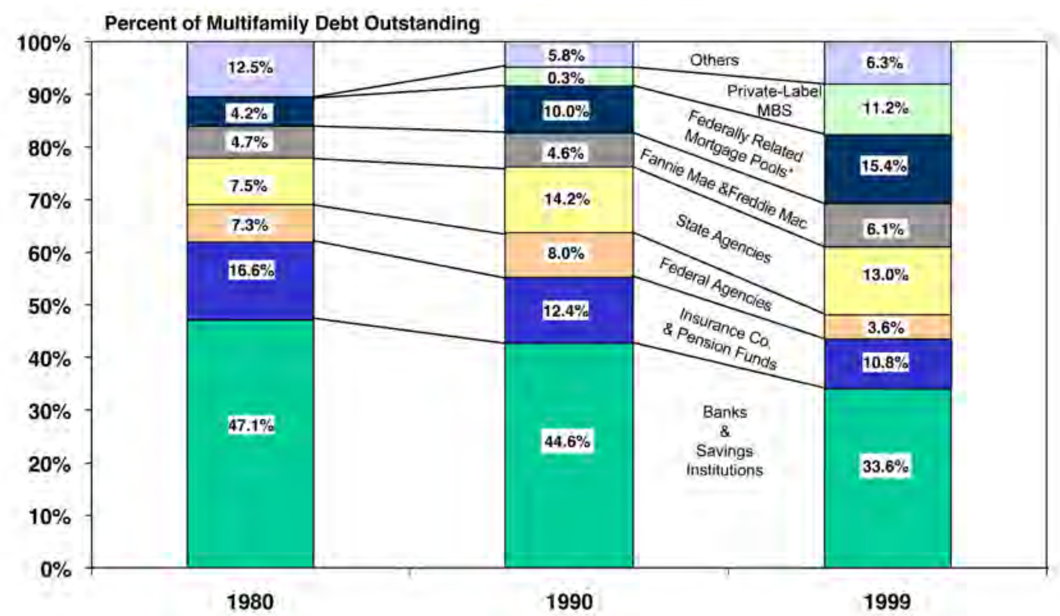
GSE Multifamily Transaction Volume in Units, 1993-1999

Source: Federal Reserve Bulletin

The collapse of the multifamily mortgage market would have been greater if it were not for the rise of Private-Label multifamily mortgage backed securities (MBSs).[10] Private-Label involvement in the secondary market revitalized multifamily lending and helped bring the multifamily market out of the 1990 recession. Specifically, life insurance companies played a major role in originating multifamily loans.[11] The exhibit below reaffirms this point and displays the percent of multifamily debt outstanding between 1980 and 1999. Note that Fannie and Freddie had a modest increase of 1.5% and Private-Label MBS had the greatest increase, with about 11%.[12]

Figure 2

Major Holders of Multifamily Debt



10 Private-Label MBS are those securities that do not conform to the loan limits set forth by the GSEs and therefore, do not have the backing of the government. They are significantly riskier and have been nearly non-existent during the recent economic crisis.

11 Segal and Szymanoski, "The Multifamily Secondary Mortgage Market: The Role of Government-Sponsored Enterprises"

12 MBS: Mortgage back securities

The 2000's

While the the late 1990's revitalized Fannie Mae and Freddie Mac's involvement in the multifamily market, the 2000's were a decade of unprecedented growth for the two GSEs. By the early 2000's, Fannie and Freddie had the largest share of multifamily debt outstanding and were increasing its share at a sizeable rate. Private–Label MBS issuers, such as life insurance companies, built off the success of the late 1990's and continued to provide multifamily debt through the mid 2000's. Most debt players, including the GSEs, hit a peak in 2003 with regards to the amount of debt outstanding each possessed, before leveling off for a couple of years.[13] In 2007, multifamily mortgage loan purchases and debt outstanding began to increase again, but not across all debt holders. The Great Recession that began in late 2007 brought the debt markets to a halt, including the GSEs.[14]

As the recession progressed through 2008, all debt holders, except for the GSEs, saw their multifamily mortgage debt outstanding level off or decline. Conversely, due to the government bailout of Fannie and Freddie, the GSEs experienced tremendous growth between 2007 and 2009, since they were the only major, active player in the multifamily industry. During this time, Fannie and Freddie had kept the multifamily mortgage market liquid. As a result, during the Great Recession, the multifamily sector fared much better than other commercial property types. The exhibit below depicts the different debt holder's involvement in multifamily mortgage debt outstanding between 1980 and 2010. Most of the players had a similar market share until early 2000. Since the Great Recession, the GSEs experienced a sharp increase in their multifamily portfolio. This has led the GSEs to their current dominance of the multifamily market.

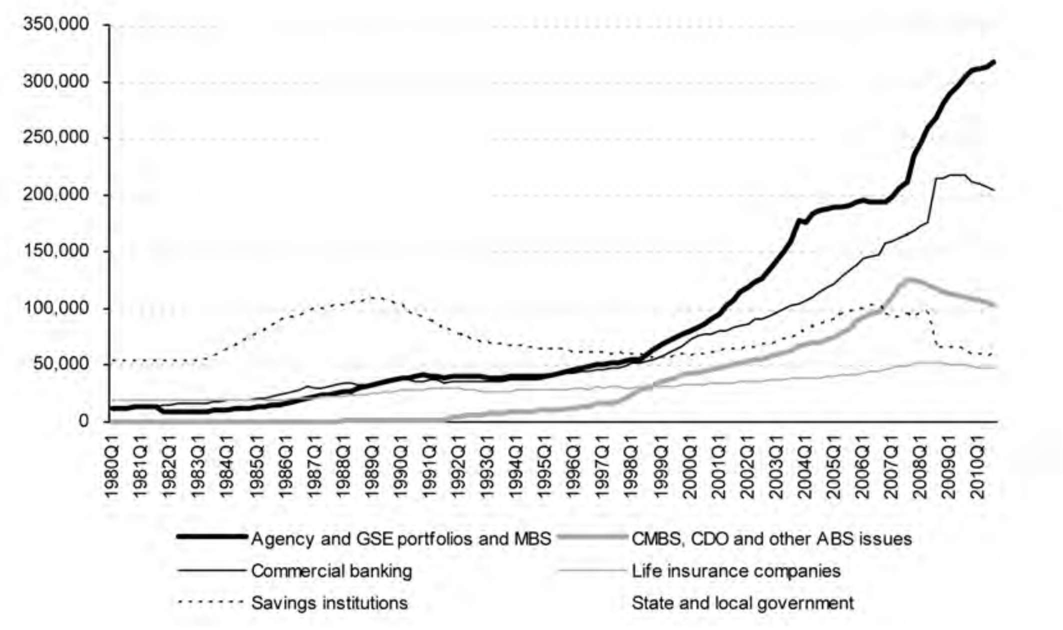


Figure 3

Multifamily Mortgage Debt Outstanding, Total Multifamily Mortgage Debt Outstanding, by Selected Sector by Quarter ($ in millions)

Source: Flow of Funds, Federal Reserve

Current Condition

As of the beginning of 2010, the GSEs accounted for over 84% of all multifamily loans originated.[15] Additionally, the GSEs own 39% of all outstanding multifamily debt, which

13 This correlated to the increase in subprime mortgages and economic downturn

14 The Great Recession is in reference to the global economic recession of the late-2000's. It is linked to reckless lending by financial institutions and a growing trend of mortgage securitization. The recession lasted from 2007 to 2009 and in 2011 the economy has still not completely recovered

15 Source: Marcus & Millichap Research, MBA

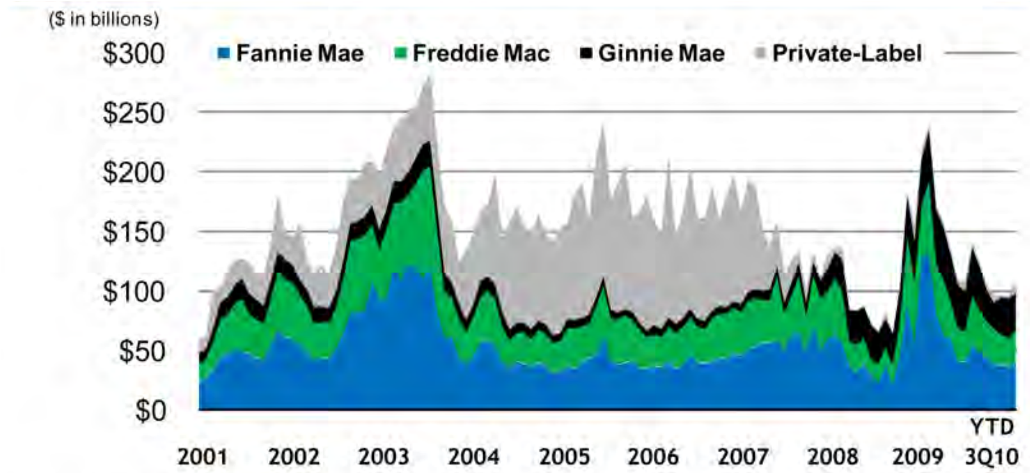
is about triple the amount owned by the private MBS market.[16] Specifically, Fannie Mae has played a significant role in providing secondary funds. As of June 30, 2010, it had provided more than 50% of all secondary funds available for finance totaling 42,000 loans and $185 billion.[17] On the other hand, in 2010, Freddie Mac only funded about $15 billion in multifamily loans.[18]

The MBS Market

In discussing the 2008 recession and the multifamily secondary market, attention should be given to mortgage-backed securities (MBS). The MBS market consists of residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS). Among other factors, reckless lending practices and an unsustainable increase in the MBS market caused the Great Recession. This led the debt markets to freeze and the GSEs to take an active involvement to keep the markets liquid. Fannie Mae and Freddie Mac are the most common security trusts in the U.S. and are known to take an active role in the securitization of residential mortgages. Their involvement in securitizing commercial mortgages is less apparent since the GSEs only securitize one commercial property type (multifamily). The chart below shows the MBS issuance volume of the GSEs and Private-Labels. Private-Label MBS had an active role in securitizing mortgages between 2004 and 2007 before becoming nearly non-existent. Its lack of involvement in the MBS market is a cause for concern for future real estate cycles.

Figure 4

Enterprises' Market Share- MBS Issuance Volume



	2001	2002	2003	2004	2005	2006	2007	2008	2009	YTD 3Q10
Enterprises	67%	68%	70%	47%	41%	40%	58%	73%	72%	67%
Ginnie Mae	13%	9%	8%	7%	4%	4%	5%	22%	25%	29%
Total Agency	80%	77%	78%	54%	45%	44%	63%	95%	97%	96%

Source: Inside MBS & ABS

CMBS Market

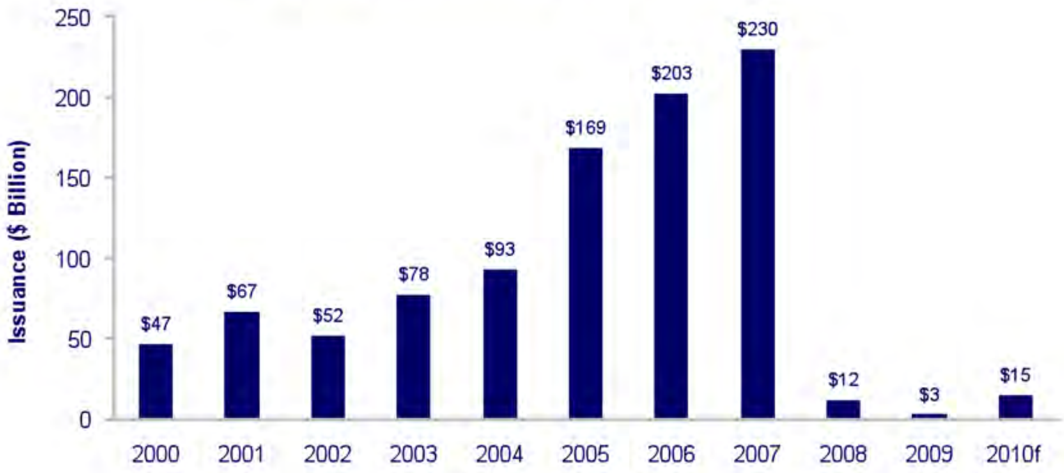
Since multifamily is an income producing property it is the only commercial asset that Fannie Mae and Freddie Mac securitize. The exhibit above illustrates that between 2004 and 2007 Private-Label MBS accounted for slightly fewer than 50% of all MBS issuance. That volume was due to its unsustainable increase in the securitization of commercial mortgages, which is shown in the exhibit below. As of 2010, the CMBS market began to show signs of recovery, but is still far from its peak in 2007. CMBS securitization volume is expected to increase considerably over the next few years.[19]

16 To the total multifamily mortgage debt outstanding is $914.3 billion. Of that amount the GSEs own $351.9 billion

17 Source: Center for American Progress

18 "Fannie Mae's Role In The Small Multifamily Loan Market"

19 Source: ING Clarion Research and Investment Strategy- "US Real Estate Market Outlook"

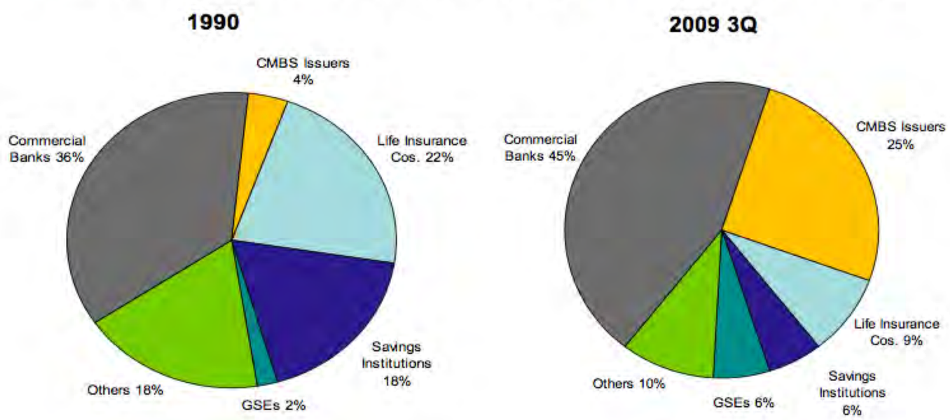


Source: ING Clarion

Figure 5

U.S. CMBS Securitization Show Signs of Life

The driving force behind the recovery of the CMBS market will be the securitization volume of Private-Label CMBS issuers. The GSEs do not have a significant involvement in the CMBS market since they only securitize one asset type. In 1990 and 2009, the GSEs only had a 2% and 6% market share, respectively. They are much larger players in RMBS and only securitize some multifamily mortgages out of an enormous pool of commercial mortgages. Therefore, reducing the role of Fannie Mae and Freddie Mac should not have a major impact on the CMBS market.



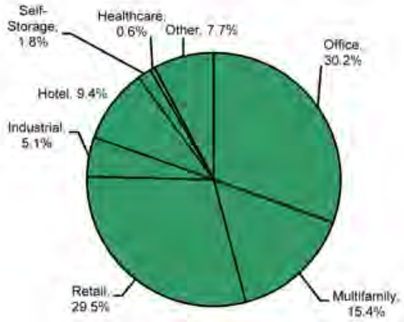
Source: Federal Reserve, Flow of Funds

Figure 6

$908 billion of the $3.4 trillion U.S. commercial and multifamily mortgage loans outstanding are held as securities, a significant increase since 1990

Although the GSEs are not a major player in CMBS securitization, multifamily property is a major asset type. In the first quarter of 2009, CMBS outstanding totaled $779.6 billion. Of this amount, multifamily securitization totaled $120.06 billion (15.4%). At this time, the GSEs had a 6% market share, which totaled $46.77 billion. In summation, the GSEs securitized about 39% of the multifamily market. While this is a relatively large percentage of the multifamily market, it is still a small share of the total CMBS market.

Total CMBS Outstanding	$ 779.6 billion
By Property Types:	
Office	30.5%
Multifamily	15.4%
Retail	29.4%
Industrial	5.1%
Hotel	9.4%
Self-Storage	1.8%
Healthcare	0.6%
Other	7.7%



MBA Commercial Real Estate Quarterly Data Book

Figure 7

Commercial Mortgage-backed Securities (CMBS) Market Composition, Composition of CMBS Outstanding, as of March 31, 2009

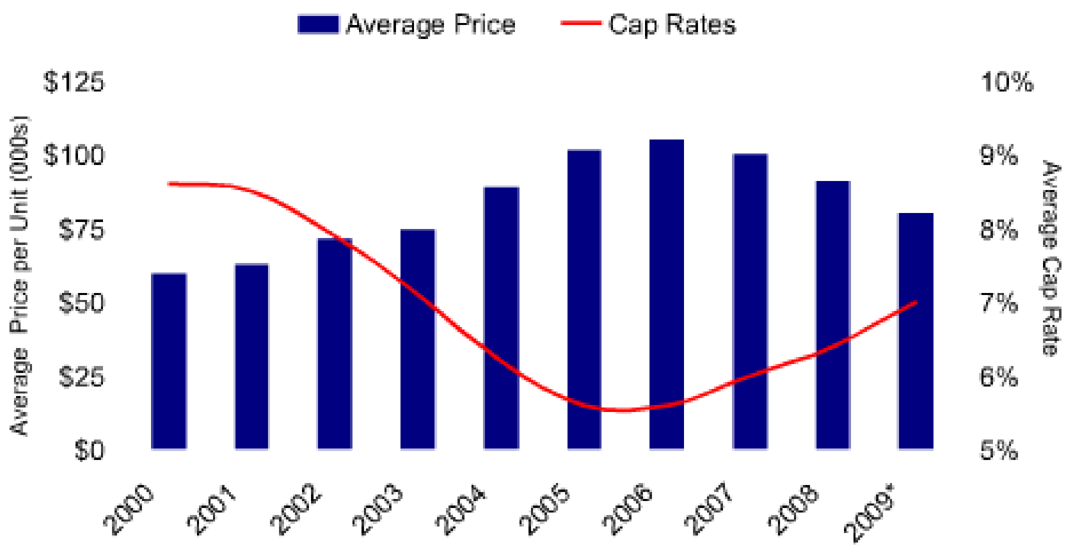
The Future of the Multifamily Market

Fannie Mae and Freddie Mac have helped keep the mortgage markets liquid during the Great Recession, but also present a direct competition to private lenders and institutions. Taking the GSEs out of the picture will clearly have an effect on the future of the multifamily industry. The extent of this will be discussed below.

In analyzing the future of the multifamily market, one must look at simple supply and demand metrics. Dismantling the GSE's will provide other lenders with the opportunity to absorb the market share and debt that Fannie and Freddie could have possessed. This will result in an *increase in borrowing costs, lender power, and stricter underwriting.* Additionally, without a GSE guarantee, bond investors will face a higher default risk. A higher risk for lenders equates to a higher return and lenders will be able to *charge higher interest rates* to make up for riskier loans. This will ultimately make it more difficult for homeowners to obtain loans. Thus, dismantling the GSEs will *increase the cost of debt, resulting in an increase in cap rates and a decrease in property prices*. This relationship is displayed in the chart below. Since 2007, Cap rates for multifamily property have slowly begun to pick up, while property prices continue to decline. Although the economy continues to recover, getting rid of the GSEs will only intensify this relationship.

Figure 8

National Apartment Price and Cap Rates



Source: Marcus & Millichap Research Services, REIS

As property prices continue to decrease so will demand for multifamily properties, resulting in multifamily construction starts slowing down even further or halting completely. Ultimately, demand will pick up, causing vacancy rates to level off and rental rates and property values to increase. This will lead to new multifamily construction starts, since the supply of multifamily properties will lag behind its demand. The process from the time demand exceeds supply to new construction starts generally ranges from two to three years.[20] The subsequent chart displays the relationship between construction starts and vacancy rates over the past decade. Since 2000, as completions decrease, vacancy rates tend to increase. Dismantling the GSEs will only continue this trend until the demand for multifamily properties will be greater than the supply and rental rates begin to increase.

[20] This average time range was acquired by speaking with industry professionals and academics

Source: Marcus & Millichap Research Services, REIS

Figure 9

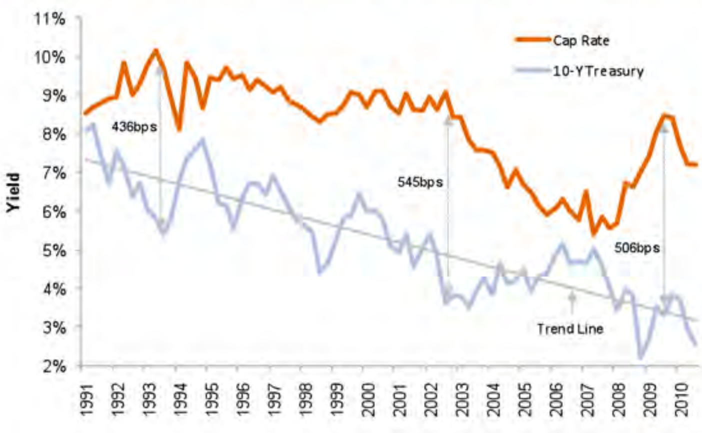
Falling Construction, Economic Growth to Stabilize Apartment Vacancy in 2010, Begin Recovery in 2011

While cap rates are covered the impact that the GSEs will have on the spread over the "risk free" treasuries is a topic for discussion. Interest rates will increase, but by how much? Previous studies focusing on the privatization of the residential mortgage market have indicated that interest rates on non-guaranteed GSE single-family conforming mortgages are 25 basis points (bps) higher than rates on similar mortgages that could be guaranteed.[21] If the change in basis points is somewhat similar between multifamily and single-family than this change will have a minimal effect on the debt markets. Mortgage rates tend to fluctuate by as much as 100 bps. Therefore, the difference in basis points due to the lack of a government guarantee will not be as big a factor as an increase in the underlying interest rates.

Treasury yields will begin to increase, but are currently still at historic lows. For example, from 1958 to 2008, there were only three months in which treasury yields were lower than they are today.[22] Since treasury yields are at historic lows, even with an increase in interest rates due to GSE dismantling, treasury yields will not increase to new historic highs, but instead would move towards the mean. The exhibit below shows the relationship between cap rates and 10-year treasuries over the past twenty years. During times of economic prosperity the gap between cap rates and treasury yields widens, which equates to an increase in risk. Currently, the spread between cap rates and treasury yields is at one of the widest points of the cycle. Dismantling the GSEs will cause both cap rates and treasury yields to increase.

Figure 10

Complex Relationship Between Cap Rates and Treasury Yields



Source: ING Clarion

21 Source: Jaffee- "Reforming the US Mortgage Market Through Private Market Incentives"

22 As of June, 2011, the 10-year treasury yield was 2.96. Source: Board of Governors of the Federal Reserve System.

The 1990 Recession vs. the 2008 Recession

During the last recession, the GSEs did not play a major role in the multifamily market. Private-Label MBS issuers helped revitalize the multifamily mortgage market in the years preceding the recession. Additionally, while the GSEs guarantee loans, they do not originate them. They do not work directly with investors and do not have a direct effect on the amount of loans created. Based on this data, the GSEs are not necessary for the multifamily mortgage market to recover. Although the GSEs offer a level of comfort during an economic downturn, Private-Label issuers should be able to provide a liquid secondary market if given the appropriate incentives and subject to stricter underwriting practices. Specifically, private lenders, depository institutions and capital market investors are all likely to have an active role in the future of multifamily loan origination.

It should be noted that, in 2009, the multifamily debt outstanding was at an all time high and double the amount of the previous recession. This should not be a cause for concern as it has more to do with the underlying reasons for each recession. One of the main causes of the 1990 recession was the crash in commercial real estate, specifically office properties. This did not have a direct effect on the demand for multifamily properties and did not cause the amount of multifamily debt outstanding to increase substantially. On the other hand, the subprime crisis led to a considerable increase in single-family defaults and demand for rental properties, causing a spike in the amount of multifamily debt outstanding.

Future of the CMBS Market

Although the GSEs have a 40% market share in the securitization of multifamily mortgages, this only equates to 6% of the total CMBS market. This alone would make one think that the GSEs would not have a significant effect on the CMBS market. On the other hand, GSE pricing of CMBS mortgages tends to be tighter than the pricing of its competitors. Therefore, if CMBS spreads for multifamily are wider than what is quoted by the GSEs they will be more expensive, resulting in pressure for cap rates to increase. While the GSEs only have a 6% share of the CMBS market, evaporating the lower pricing can lead to an increase in cap rates and decrease in values. CMBS mortgage spreads may slightly widen without the presence of the GSEs, but Private-Label CMBS issuers should be able to absorb the market without much consequence.

Conclusion

In conclusion, the multifamily market will suffer through a supply and demand cycle that will see interest rates increase and property prices decrease. Eventually, multifamily properties will rebound in value and rental rates will begin to increase, but this will not happen until demand exceeds supply and new construction is necessary. In the meantime, historical data over the past twenty years indicates that given proper incentives, Private-Label CMBS issuers should be able to absorb the market share that the GSEs possess in the multifamily mortgage market and CMBS market. While Fannie Mae and Freddie Mac have played an active role in the recovery of the multifamily market from the 2008 recession, their existence is not a necessity for a healthy multifamily market.

Afterward

There is much uncertainty with what will actually be done with the GSEs over the next decade. The GSEs have been involved in the multifamily mortgage industry since the mid 1980's and removing them will have an impact on the mortgage markets. The extent of this impact is unknown due to the somewhat ambiguous plan of the US Treasury. The following are topics that should be considered going forward:

- The US government is known for moving slowly. How long will it take for the GSEs to "wind down" their involvement in the secondary mortgage market?
- Given the government's slow movement, will it still want to remove the GSEs if they begin to become profitable again?
- What role will the GSEs play, if any, in the future of the mortgage market? Will the GSEs still have an active role in low-income housing?

Changing Trends

- Demand for housing in centrally located business districts is projected to continue to increase, which should increase demand for multifamily units.
- The Great Recession has left a level of uncertainty regarding the security of employment. Americans must ask themselves if it is financially better to rent or own?